529 College Savings Plans

Distribution Strategies

Did you know there are 3 ways you can take a distribution from a 529 plan? As the account owner when it comes time to take a withdrawal to pay for college expenses you may be wondering, should I make the distribution check payable to me, my son or directly to my son's school? When should I take the withdrawal? Should I take the withdrawal when my daughter's tuition is due or reimburse myself at the end of the year? Below are some strategies and tips to help you make the best decision for you and your family.

3 ways to take a 529 withdrawal

1. **Make the check payable to you (account owner)**

   When the check is made payable to you as the account owner the 529 program manager will issue Form 1099-Q with your name and SSN on it. A box on Form 1099-Q is checked, indicating that the "distributee" is someone other than the beneficiary. This may trigger a notice from the IRS to you even if the distribution was used for the beneficiary's higher education expenses during the year. You will now have to respond to the IRS and justify the exclusion of earnings. This may be a bit of a hassle.

   If the IRS would view part or all of the withdrawal as non-qualified, the earnings portion would be treated as ordinary income and therefore taxed at the account owner's tax bracket (your tax bracket) instead of the other option which would be taxable to the beneficiary at their tax bracket. This could happen if the student received a scholarship and you made a decision to withdrawal unneeded funds from the 529. You are not able to "return" the funds to the 529.

   If you prefer to reimburse yourself and find it a convenience, this can be a good option.

2. **Make the check payable to the student's college**

   As the account owner you have the option to make the check payable directly to the school. The Form 1099-Q will show the student's name and SSN. Be cautious. Some schools receiving a payment directly from a 529 plan will treat it the same way as an outside scholarship. If a student receives assistance from an "outside source" the school can adjust that assistance downward on a dollar-for-dollar basis. Therefore, reducing the student's financial aid need the following year when you apply for the FAFSA. It is recommended you contact your child's college to ask about their policies.

   If you find it easiest to make the check payable to the school and the school doesn't view money from a 529 plan as an outside source then this can be a good option.

3. **Make the check payable to the beneficiary (student)**

   The advantage of having the check made payable to the student is that the Form 1099-Q will show the student's name and SSN. If the student incurs qualifying higher education expenses (QHEE) during the calendar year that are equal to or greater than the gross distribution figure on Form 1099-Q, the distribution is tax free. Nothing will then show on the student's Form 1040. The IRS can still do an audit on the return but it is less likely since they assume the withdrawal will go towards higher education expenses for that student and the earnings were properly excluded.

   If you withdraw more then what was needed to pay for higher education expenses in any given calendar year, then the earnings portion would be taxable at the beneficiary's tax bracket which is typically much lower than your tax bracket, and a 10% penalty would be assessed on the earnings portion.

Best Strategy

So now you know your options and you are probably wondering what the BEST option is for taking a withdrawal from my 529? In most scenarios the most advantageous option is to make the check payable to the student. However your situation is unique and your Baird Financial Advisor can help you talk through your options.

Timing of the 529 withdrawal is important

Knowing when to take a withdrawal is important to avoid being taxed and penalized later. 529 distributions need to be taken in the same **calendar year** that you pay for qualified higher educational expenses (QHEE), otherwise the distribution will be considered non-qualified and the earnings portion would be subject to a 10% penalty and the earnings portion would be treated as ordinary income and taxable to the recipient.

For example: You don't want to make the mistake of paying all 4 years of your child's college costs from your savings account and then in your child's senior year taking a full withdrawal from your 529 to reimburse yourself. Remember you can only reimburse yourself from the 529 for the expenses paid for that **calendar year**. Therefore in this example the first 3 years would be considered non-qualified expenses and the earnings portion (pro-rated portion of the nonqualified distribution) would be taxed and penalized.

Investors should consider the investment objectives, risks, charges and expenses associated with a 529 Plan before investing. This and other information is available in a Plan's official statement. The official statement should be read carefully before investing.

Depending on your state of residence, there may be an in-state plan that provides tax and other benefits not available through an out-of-state plan. Robert W. Baird & Co. does not provide tax advice. Before investing in any state's 529 plan, you should consult your tax adviser.

Robert W. Baird & Co. 777 East Wisconsin Avenue, Milwaukee, Wisconsin 53202. 1-800-RW-BAIRD. www.rwbaird.com
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